



89-SBE-012

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BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JAMES C. AND FERN CROCKER) No. 82A-1187-CB
83A-1170

For Appellant: James C. Crocker

For Respondent: Karen D. Smith
Counsel

O P I N I O N

This appeal is made pursuant to section 18593^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of James C. and Fern Crocker against proposed assessments of additional personal income tax and penalties in the total amounts of \$1,022.40 and \$1,479.45 for the years 1977 and 1979, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

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The issue presented in this appeal is whether appellants' trust should be recognized for tax purposes.

On December 3, 1977, appellants and their married daughter, Mrs. Foti, executed a document entitled "Trust Agreement" to create the Jebbcoff Trust. Appellant-husband executed the document as grantor while appellant-wife and Mrs. Foti signed as trustees. Appellant-husband purportedly transferred various real and personal properties to the trust allegedly in exchange for 100 beneficial unit certificates. Thereafter, the 100 units were cancelled and reissued as follows:

<u>Beneficiary</u>	<u>Relationship</u>	<u>Number of Units</u>
James C. Crocker	Grantor	20
Fern Crocker	Wife	50
Elaine Foti	Daughter	5
Barbara Crocker	Daughter	15
Beverly Crocker	Daughter	5
James D. Crocker	So'n	5

Appellants incorporated their business, Crocker Drug, on November 14, 1977. Crocker Drug and the trust entered into an agreement which included, among the various terms, that the trust would manage the non-pharmacy part of the drug store and the trust would lease to Crocker Drug \$30,000 worth of fixtures that it purportedly owned in exchange for a reasonable portion of gross receipts.

Respondent determined that the trust was designed with the sole purpose of avoiding income tax. Among the reasons for the respondent's determination were the following: (1) the family residence at 10875 Challenge Way, La Mesa, California, was depreciated on the trust's tax return; however, appellants continued to live in it and claim the homeowner's exemption on it throughout the appeal period; (2) any property conveyed to the trust was community property, thus making appellants co-grantors of the trust; (3) there was no adverse trustee; (4) appellants lived in the Challenge Way residence for one-and-a-half years rent free and apparently did not pay the reasonable rent; (5) expenses deducted by the trust were personal expenses of appellants including: (a) telephone and utilities, (b) cable TV payments, and (c) payments for Wallace sterling silverware; (6) the trust depreciated properties of appellants including: (a) a vacuum cleaner, (b) a bedroom set, and (c) silverware; (7) appellant-husband was able to sign checks drawn on the trust account without any other signature; and (8) appellants could use and control all trust assets in

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the same manner as they had before the trust's formation, since together the appellants formed a majority of the trustees and appellant-husband was executive trustee.

It is a fundamental principle of income taxation that income must be taxed to the one who-earns it. (Commissioner v. Culbertson, 337 U.S. 733 [93 L.Ed. 16591 (1949)].) It is equally well settled that deductions are a matter of legislative grace, and the burden is upon the taxpayer to show that he is entitled to the deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 13481 (1934)].) Appellants bear the burden of showing that the trust was other than a tax-avoidance scheme. They have not satisfied their burden, since they have not produced evidence that would indicate they did not have any of the several powers which result in the grantor(s) being treated as the owner(s) of all of the trust. (Rev. & Tax. Code, §§17781-17792.)

Appellants contend that no tax sham was intended and that they used legal counsel to try to legally reduce their taxes. Appellants argue that Mrs. Crocker was an adverse trustee, not a grantor. Also, appellants assert that the Internal Revenue Service accepted the trust's tax return for the period ended February 1978.

Where, as here, the grantor and members of his family are trustees and beneficiaries, the trust must be closely scrutinized for economic substance. (Markosian v. Commissioner, 73 T.C. 1235 (1980); Patterson v. Commissioner, ¶ 84,339 T.C.M. (P-H) (1984).) As in Patterson v. Commissioner, supra, appellants controlled both the income-generating assets conveyed to the trust and the disposition of income earned from such assets. For the relevant years, appellants were a majority of the trustees. Each appellant had authority to disburse trust assets, individually, as signatories on the trust bank account. It is clear that the trust was created to reduce appellants' income tax and establish deductions for otherwise nondeductible personal expenses. The trust's continued existence, everyday functioning, and eventual demise were completely dependent upon appellants.

A family trust will be treated as a grantor's trust where the grantors control the disposition of the income or corpus of the trust without the consent of an adverse party. (See Rev. & Tax Code, § 17784; Rev. Rul. 75-257, 1975-2 C.B. 251.) Even though appellant-husband was described as the only creator and grantor of the trust, the property that appellants contend was transferred to the trust must be presumed to have been community property, thus making appellant-wife a co-grantor

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and not an adverse trustee. (See Civ. Code, § 5110; Patterson v. Commissioner, supra.) Therefore, appellant-wife may properly be held to be the owner of that portion of the trust for which she made distributions of trust assets to herself.

Appellants' absence of good faith regarding their conveyances to the trust is further revealed in the fact that, despite the conveyance of the family residence to the trust, they continued to claim the homeowner's exemption on the subject property even though the homeowner's exemption is only available with respect to dwellings which are occupied by the owner as a personal residence. (Rev. & Tax. Code, § 218 et seq.) If appellants terminated their interest in the family residence by virtue of their conveyance to the trust, the subject property would have been ineligible for the homeowner's exemption. Furthermore, by deducting appellants' personal expenses and depreciating the personal residence, it is clear that the trust was nothing more than a tax-avoidance device.

Appellants have provided no substantiation that the IRS reviewed the validity of the trust on audit. In any event, it is well established that the respondent and this board are not bound to adopt the conclusion reached by the IRS in any particular case, even when the determination results from a detailed audit. (Appeal of David G. Bertrand, Cal. St. Bd. of Equal., July 30, 1985.)

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of James C. and Fern **Crocker** against proposed assessments of additional personal income tax and penalties in the total amounts of \$1,022.40 and \$1,479.45 for the years 1977 and 1979, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 11th day
of May, 1989, by the State Board of Equalization, with
Board Members Mr. Carpenter, Mr. Collis, Mr. Bennett and
Mr. Davies present.

<u>Paul Carpenter</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>John Davies*</u>	, Member
<u> </u>	, Member

*For Gray Davis, per Government Code section 7.9